No. 10240

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

DAILY JOURNAL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF FOR PETITIONER.

LATHAM & WATKINS,
1112 Title Guarantee Building, 411 West Fifth Street, Los Angeles, California,
Attorneys for Petitioner.

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TABLE OF AUTHORITIES CITED.

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REPY BRIEF FOR PETITIONER.

I.

Respondent Misstates the Issue Involved.

Respondent states that the question presented is "whether the taxpayer is entitled * * * to deduct the full amounts paid to its president, Douglas W. Wilson, as reasonable compensation for services rendered by him to another corporation during each of the taxable years 1936, 1937 and 1938." (Br. 2.)

This statement *assumes* that petitioner, in conducting the affairs of Consolidated through said Wilson, was not

carrying on a trade or business and that Wilson in managing Consolidated was *not* acting for petitioner. But these are the very issues which this Court must decide in this proceeding.

As has been repeatedly pointed out, petitioner contends that its president in managing the affairs of Consolidated *was acting for petitioner and no on else.* Petitioner further contends that after the consolidation in 1929, petitioner's trade or business was the management of the new company, and that it could only and did carry on such trade or business through its agent, Wilson. Finally, petitioner submits that the salary paid Wilson for services thus rendered petitioner was reasonable and constituted an ordinary and necessary expense of petitioner's trade or business and was hence deductible in determining petitioner's taxable net income.

These are the *real* issues in this case.

Respondent has assumed that petitioner is claiming the disputed deduction on the theory that its business is that of Consolidated, that is, accepting advertisements, printing papers, etc. Such is not the case. *Petitioner's business is the management of its principal investment. This management is active, not passive.* This management can likewise only be effected by operating Consolidated through petitioner's agent, Wilson. This method of approach, which is fundamental, has been overlooked entirely by respondent.

II.

Respondent Is Mistaken in His Understanding of the Facts Involved.

(a) Respondent states (Br. 16) that under the consolidation agreement, the "officers" of the new corporation were required to use their best efforts to further and promote the latter's business.

The fact is that the *predecessor corporations including petitioner* were the persons who were required to "use their best efforts and endeavors to further and promote the business of said new corporation" [Tr. 118]. This is exactly what petitioner was doing in requiring its president, Wilson, to manage Consolidated.

(b) Respondent states (Br. 17) that petitioner "had substantially no more control over Consolidated than the other stockholders." This statement is entirely incorrect as is indicated by the holdings of petitioner in Consolidated during the years in question [Tr. 34].

	Class B Preferred	Common
Total Shares Outstanding	5,000	3,500
Shares Owned by Petitioner	3,258	2,340

Likewise, on cross-examination, Wilson stated, "We control the board of directors on the Consolidated. Therefore, our decision is final on any action taken" [Tr. 85].

Petitioner lacked complete control of Consolidated only with respect to the salaries to be paid by it to its executive officers. Here the original consolidation agreement

required the unanimous consent of Consolidated's Board of Directors. This was agreed to by the parties to the consolidation including petitioner, because it was always assumed that petitioner would manage Consolidated through petitioner's president, and that for such services rendered to petitioner by its president, petitioner would compensate him.

(c) Respondent states (Br. 17), "Wilson plainly was not required to devote any of his time or efforts to the direct management of the taxpayer's (petitioner) affairs."

The evidence with regard to this point is all to the contrary. Wilson's testimony [Tr. 63-90] conclusively shows he was required and directed by petitioner's Board of Directors to manage Consolidated. In complying with these instructions, he was hence *working directly for petitioner.*

In other words, respondent in this proceeding *assumes* that petitioner's business could not possibly consist of the management of Consolidated. Upon this premise, respondent grounds his entire argument.

III.

Respondent Clearly Erred in Concluding That Petitioner Was Not Engaged in the Business of Managing Its Principal Asset, Namely Consolidated, During the Years in Question.

Respondent's argument in this particular is apparently based upon the following considerations:

(a) It is claimed that petitioner had no more control over the affairs of Consolidated than did its other stockholders. As has already been pointed out, this was clearly not true.

(b) Since a portion of the benefits accruing from the management of Consolidated through Wilson accrued to others than petitioner, it is claimed that petitioner's business could not consist of the operation of Consolidated.

Throughout his brief, respondent seems to contend that petitioner's business cannot consist of the management of Consolidated because petitioner did not own *all* of Consolidated's stock. This we submit is totally without merit. The extent of stock ownership is of little value in determining whether or not the taxpayer is engaged in business with respect to the corporation in question. A taxpayer may own 100% of a corporation's stock and still not be engaged in the business of managing said company. At most, it would seem that a taxpayer need only own a majority of the stock since such majority would be required for the control which is generally necessary for effective management. More than majority control clearly existed here.

In *Helvering v. Highland, Exec.,* 124 Fed. (2d) 556 (C. C. A. 4th, 1942) the decedent's estate owned a *majority only* of the stock of the Clarksburg Publishing Company. Said estate's executor was the president and general manager of said corporation. The Court held that the estate was engaged "actively in the newspaper business."

It seems too clear to require further elaboration that the bases upon which respondent grounds his contention that petitioner was not engaged in business so far as Consolidated was concerned are without merit.

IV.

Respondent Has Confused the Law Applicable to This Proceeding.

(a) In its opening brief, petitioner cited and relied on the cases of *Foss v. Commissioner,* 75 Fed. (2d) 323 (C. C. A. 1st, 1935), *Marsch v. Commissioner,* 110 Fed. (2d) 423 (C. C. A. 7th, 1940) and in particular on *Helvering v. Highland, supra.*

Respondent brushes these authorities aside, stating that they "are distinguishable" (Br. 23). He later says: "those cases, however, are not in point" (Br. 24). No reason for such statement appears any place in respondent's brief, nor does respondent even attempt to point out why they are distinguishable or not in point.

Respondent then refers to the cases of *Kane v. Commissioner,* 100 Fed. (2d) 382 (C. C. A. 2d, 1938) and *Miller v. Commissioner,* 102 Fed. (2d) 476 (C. C. A. 9th,

1939). With respect thereto, respondent says that both the last two named cases hold

> "substantially that the taxpayers' activities in handling their own properties and investments did not constitute a trade or business within the meaning of the statutes authorizing deductions for ordinary business expenses in computing taxable net income. The *Kane* and *Miller* cases are in accord with the rules since laid down by the Supreme Court in *Higgins v. Commissioner,* 312 U. S. 212, which in effect overruled such decisions as those relied upon by the taxpayer in the *Foss, Marsch and Highland* cases * * *."

It is obvious that respondent's brief was prepared in haste. The *Higgins* case was decided by the Supreme Court February 3, 1941; the Fourth Circuit Court decided the *Highland* case on January 5, 1942, almost a year later. Under no circumstances did the Fourth Circuit feel that it was failing to follow the Supreme Court's interpretation of the law in the *Higgins* case. In fact, the Court in the *Highland* decision referred to and quoted from said *Higgins* decision.

In the *Higgins* case, a "passive investor" sought to deduct the expenses of maintaining an office from which said investments were managed. In denying the deduction, the Supreme Court said in part: "To determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case. * * * The petitioner merely kept records and collected interest and dividends from his securities. * * *"

The *Kane* and *Miller* cases specifically recognized the legal principle for which petitioner is here contending,

and which was later announced by the Supreme Court in the *Higgins* case. In the *Kane* proceeding, the taxpayer sought to deduct fees paid to a trust company for collecting income and amounts paid for office rent and bookkeeper's salary. In denying the claim, the Court said in part: "In the prevailing opinion of the Board, it was said that the taxpayer 'merely received income from investments and this is not a trade or business.' While we do not say that a taxpayer might not carry on a business through an agent, it was not shown here that enough was done either by the taxpayer or her agents to constitute the carrying on of a business."

In the *Miller* case, we have the same situation. There the decedent Bloom engaged in no business except the supervision of the investments of a revocable trust. He maintained an office which he visited a few hours every day. He employed two individuals to do clerical work, make up income tax returns, and read trade journals and financial services.

It is too obvious to require extended consideration that Mr. Bloom was a passive investor, and was not engaged in a trade or business. He was hence not entitled to a deduction for the salaries of his clerks, and the rent of his office.

Respondent is clearly in error, therefore, in stating that the *Higgins* case overruled the cases cited and relied upon by petitioner. It obviously could not overrule a case decided a year later.

Further, the *Kane* and *Miller* cases are not in conflict with the *Foss, Marsch* and *Highland* cases. The Courts in the *Kane* and *Miller* proceedings simply found that the

taxpayers were passive investors. *Upon the facts, no other conclusion could possibly have been reached.* In the *Foss, Marsch* and *Highland* cases, the Courts found that because of the facts involved, the taxpayers were carrying on a trade or business. That is exactly what petitioner contends in the instant proceeding. Again, we submit that the facts preclude any other finding.

(b) The cases cited by respondent in his brief are not in point here.

Respondent cites a number of cases in which taxpayers were denied the deductions claimed. It is unnecessary for us here to comment in detail with respect to such cases. We have examined them all, and we respectfully submit that they fall into either one or the other of the following classifications:

(1) No contention was made by the taxpayer that the expenditure was in connection with his trade or business. *Coosa Land Co. v. Commissioner,* 29 B. T. A. 389 (1933). Here the company with respect to which the taxpayer made the challenged expenditure *had suspended operations.* Not only did the taxpayer not contend that its trade or business was the management of said company, but such a contention had it been made could obviously not have been sustained.

(2) The Court found that as a matter of law, the activity of the taxpayer did not constitute the carrying on of a trade or business as that term was used in the applicable statute. The case of *Kane v. Commissioner, supra,* is an example.

Respondent has failed to indicate why petitioner in managing Consolidated was not carrying on a trade or business. By the same token, he has made no effort to distinguish the case of *Helvering v. Highland, supra, the most recent of all the cases cited,* which we respectfully contend is squarely in point and should carry great weight with this Court.

Conclusion.

In conclusion, the following is respectfully submitted:

(a) Petitioner was clearly engaged in the business of managing Consolidated during the years in question.

(b) There is no real dispute as to the law applicable. Petitioner respectfully asserts that this proceeding falls squarely in the rule announced in the case of *Helvering v. Highland, supra.*

It follows that the amounts paid by petitioner to its president, Wilson, are deductible as ordinary and necessary expenses in the years involved.

(c) On respondent's own statement, any other conclusion will work a harsh and inequitable result upon petitioner. (Respondent's Brief, 27.)

Respectfully submitted,

LATHAM & WATKINS,
By DANA LATHAM,
RONALD C. ROESCHLAUB,
1112 Title Guarantee Building, 411 West Fifth Street, Los Angeles, California,
Attorneys for Petitioner.

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DAILY JOURNAL COMPANY)
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SUPPLEMENTAL LIST OF AUTHORITIES
FOR RESPONDENT SUBMITTED AT ORAL
ARGUMENT, MARCH 22, 1943.

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SUPPLEMENTAL LIST OF AUTHORITIES
FOR RESPONDENT SUBMITTED AT ORAL
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Insert, Respondent's
Brief.

On conclusiveness of Board's findings, whether of primary or ultimate fact--

p. 15 Wilmington Trust Co. v. Commissioner, 316 U. S. 164.

" " J. M. Perry & Co. v. Commissioner, 129 F.(2d) 126, 125 (C.C.A. 9th).

On deductibility of payments--

p. 18 Burnet v. Clark, 287 U. S. 410.

Deputy v. duPont, 308 U. S. 488, 493-494.

" " Esmond Mills v. Commissioner, decided by the Circuit Court of Appeals for the First Circuit January 7, 1943.

" " Interstate Transit Lines v. Commissioner. 130 F.(2d) 136 (C.C.A. 8th), certiorari recently granted by Supreme Court.

Capital expenditure

Insert, Respondents Brief.

On personal holding company surtax issue--

p. 28 — American Package Corp. v. Commissioner. 125 F.(2d) 415 (C.C.A. 4th).

" " — O'Sullivan Rubber Co. v. Commissioner, 120 F.(2d) 845 (C.C.A. 2d).

Insert, Respondent's Brief, p. 31:

"SEC. 352. DEFINITION OF PERSONAL HOLDING COMPANY.

"(a) General Rule.--For the purposes of this title and of Title I the term 'personal holding company' means any corporation if--

"(1) Gross income requirement.--At least 80 per centum of its gross income for the taxable year is personal holding company income as defined in section 353; but if the corporation is a personal holding company with respect to any taxable year, then, for each subsequent taxable year, the minimum percentage shall be 70 per centum in lieu of 80 per centum, until a taxable year during the whole of the last half of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 70 per centum of the gross income is personal holding company income; and

"(2) Stock ownership requirement.--At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.